

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF DELAWARE

IN THE MATTER OF THE COMMISSION'S)	
REVIEW OF DELMARVA POWER'S RETAIL)	
ELECTRICITY PRICING AND POTENTIAL)	
LONG-TERM APPROACHES TO SECURE)	DOCKET NO. 14-0283
LOWER PRICED ENERGY)	
(OPENED AUGUST 19, 2014))	

**THE DELAWARE PUBLIC SERVICE COMMISSION STAFF'S COMMENTS ON
AND RECOMMENDED CHANGES TO DELMARVA POWER'S LONG-TERM
APPROACHES TO SECURE LOWER PRICED ENERGY**

May 11, 2017

The Delaware Public Service Commission (“PSC” or “Commission”) Staff (“Staff”) submits the following comments and recommendations in Docket No. 14-0283, the Commission’s Review of Delmarva Power’s Retail Electricity Pricing and Potential Long-Term Approaches to Secure Lower Priced Energy for residential and small commercial - industrial customers (“RSCI”).

Background

In March 1999, the legislature enacted the “Electric Utility Restructuring Act of 1999.”¹ (“Act”) In that legislation the General Assembly declared that it is the policy of this State to encourage a competitive market for the supply of electricity and the availability of customer choice among electric suppliers. It further provided for the deregulation of generation, supply and sales of electricity² by adding Chapter 10, Electric Utility Restructuring, to Title 26 of the Delaware Code. Prior to restructuring, the generation, transmission and distribution of electric power by Delmarva Power & Light Company (“Delmarva”) was fully regulated by the PSC. After restructuring, the generation or supply of electric power became deregulated at the state level, and subject to the regulatory structure of the Federal Energy Regulatory Commission (“FERC”) as implemented by PJM Interconnection (“PJM”), a FERC-approved Independent System Operator in 1997.³

As provided by the Act,⁴ the Commission opened Docket No. 99-163 for the purpose of reviewing Delmarva’s plans for implementing retail competition. On September 29, 1999, the Commission approved an amended version of Delmarva’s restructuring plan which provided for a 7.5% rate reduction, residential rate freeze transition through September 30, 2003, and an approval to recover certain stranded costs associated with disposal of its generating assets.

In 2001, Delmarva filed an application to merge with Potomac Electric Power Company. As part of that settlement, and under PSC Order No. 5941, revised rates were established to take effect at the end of the transition period (as set forth in Docket No. 99-163), October 1, 2003, and to continue until May 2006. During this early restructuring time frame, the Commission regulated the utility’s transition process by addressing deferred restructuring issues and approving a market based approach to securing electric supply.

In Docket No. 04-391 the Commission issued Order No. 6746, dated October 11, 2005, which approved a Settlement Agreement with amendment that permitted Delmarva to establish a Request for Proposal (“RFP”) process for the purpose of procuring supply from the wholesale electric markets for resale to its Standard Offer Service (“SOS”) customers, in accordance with the Act. This

¹ 72 Del. Laws, c.10 (1999).

² See *Id.* § 3 “...the generation, supply and sale of electricity, including all related facilities and assets, shall no longer be regulated by the Commission as a public utility service or function.”

³ *Regional Transmission Organizations*, Order No. 2000, 65 FR 809 (Jan. 6, 2000), FERC Stats. & Regs. ¶ 31,089 (1999), *order on reh’g*, Order No. 2000-A, 65 FR 12088 (Mar. 8, 2000), FERC Stats. & Regs. ¶ 31,092 (2000), *aff’d sub nom. Public Utility District No. 1 of Snohomish County, Washington v. FERC*, 272 F.3d 607 (D.C. Cir. 2001).

⁴ *Supra* n.1.

Settlement Agreement sought to provide rate stability for RSCI customers through the procurement of a portfolio of laddered 3 year contracts.⁵

One month before electricity prices for Delmarva were set to expire in May 2006, the legislature again amended Chapter 10 of Title 26 by instituting the Electric Utility Retail Customer Supply Act of 2006 (“EURSCA”).⁶ EURSCA defined “Standard Offer Service Supplier” as “the electric distribution company serving within its certificated service territory.”⁷ Through EURSCA, the legislature additionally provided that on or after May 1, 2006 Delmarva’s customers shall have the opportunity but not the obligation to purchase electricity from their choice of electric supplier.⁸ EURSCA also updated the requirements of standard offer suppliers, mandating an SOS product which is safe, efficient, adequate and reliable.⁹ A number of provisions were added to stabilize electricity pricing but carried forward the RFP process for procuring at least 30% of Delmarva’s overall SOS load through the regional wholesale market via a bid or auction process.¹⁰ These provisions came at a time when rates were expected to increase by more than 50% after the expiration of the fixed rates approved by the Commission in Order No. 5941; the legislature gave RSCI customers a rate deferral plan and the ability to opt out of the deferral plan. Among other things, EURSCA granted further authority to the Standard offer service supplier to:¹¹

- (1) Enter into short and long-term contracts for the procurement of power necessary to serve its customers
- (2) Own and operate facilities for the generation of electric power
- (3) Build generation and transmission facilities (subject to any other requirements in any other section of the Delaware Code regarding siting, etc.)
- (4) Make investments in Demand-Side resources, and
- (5) Take any other Commission-approved action to diversify their retail load.

On June 20, 2006 in Docket No. 04-391, the Commission considered its approach to implementing the new legislation and determined the type of bid or auction process that Delmarva would follow to procure SOS supply. The Commission Order issued that day, Order No. 6943, summarized the situation:

In a series of earlier Orders in this docket [04-391], the Commission managed how Standard Offer Supply (“SOS”) services would be provided to retail consumers within the electric distribution service territory of Delmarva Power & Light Company (“DP&L”). The Commission chose DP&L as the SOS supplier and endorsed a “market-based” regime as the means for DP&L to acquire the necessary wholesale electricity supply to meet its SOS load.

⁵ This laddered replacement mechanism provides for the annual replacement of expiring 3 year contracts; such annual replacement represents 1/3 of SOS supply, with the remaining 2/3 being served by previously procured 3 year contracts.

⁶ 75 Del. Laws, c.242 (2006).

⁷ *Id.* at §2.

⁸ *Id.* at § 4.

⁹ *Id.* at § 8.

¹⁰ *Id.* at § 6.

¹¹ *Id.*

In particular, for “fixed price” retail SOS services, the procurement method was to be a competitive-bid, Request for Proposal (“RFP”) process that would result in multiple requirements’ contracts between DP&L and one or more wholesale suppliers. The Bid Plan was approved on October 11, 2005 in Order No. 6746 and the first wholesale competitive bid process was completed by February 2006. In December 2005 and January 2006, DP&L utilized this RFP process to procure supply for its post-May, 2006 fixed-price SOS services. The process culminated in supply contracts with six successful bidders.

On September 17, 2007, the Commission issued Order No. 7284 approving the revised Full Service Agreement and RFPs for the 2008 delivery year to be in place by October 1, 2007. The fixed-price full requirement service (“FRS”) contracts include energy, capacity and ancillary service and losses at a single price for all hours in the contract¹² and suppliers are responsible for a given percentage of the SOS load. The wholesale supplier assumes all risks associated with load and wholesale market price variations; this transfer of risk is embedded in the bid as a risk premium. Order No. 7461 determined that the specific auction mechanism for the procurement of SOS supply should be the reverse auction process and unbundled the requirement that wholesale electricity suppliers provide RECs/SRECs to Delmarva.¹³

Delmarva currently provides electric SOS to approximately three hundred thousand (300,000) residential, commercial and industrial customers in Delaware. The electricity supply is currently acquired through a wholesale reverse auction process whereby bidders are invited to bid on blocks approximately 50 megawatts in size. Multiple blocks make up a single tranche to provide service over specific periods of time. For RSCI customers, bidders are asked to bid on three year contracts totaling 1/3 of the load such that only 1/3 of the total load contracts are expiring, and are therefore renewed, each year. This ladder approach was specifically designed to reduce energy price volatility to customers and has continued for more than 10 years. In addition to the cost of SOS supply contracts, Delmarva is permitted to recover expenses related to the administration of SOS along with a reasonable allowance for retail margin.

On August 14, 2014, Commission Staff submitted a motion to open a docket seeking a review of retail electricity supply prices on behalf of Delmarva customers and consideration of long term alternative supply options. By Order No. 8619, dated September 30, 2014, the Commission granted Staff’s motion and opened the instant proceeding.¹⁴

As a result of the Commission’s guidance in Order No. 8619, Staff contracted with London Economics International LLC (“LEI”) to review alternative electricity procurement processes for the provision of SOS. Specifically, Staff sought information and analysis of potential long-term (20-25 years) approaches for the procurement of SOS supply for Delmarva’s RSCI customers with the goal of reducing such supply costs while maintaining appropriate levels of price stability over the long-

¹² Fixed price FRS contracts can have a different bid price by season (winter/summer).

¹³ Order No. 7461 (October 7, 2008) “Under the reverse auction process, once an opening price is established, the participants must bid their price offers down against the live and lowering bids of all auction participants. The auction provides price feedback until the auction closes and the lowest priced bid wins. The winning lowest bidder is paid the winning lowest price bid in the auction.”

¹⁴ Order No. 8662 dated November 13, 2014 reassigned a case manager.

term.¹⁵ Staff conducted a workshop on September 15, 2015 to receive input from stakeholders on this matter. LEI subsequently issued a report titled “Electricity Supply Procurement Assessment” on September 23, 2015. A written comment period closed on October 30, 2015 after which LEI submitted its “Review of Alternative Electricity Procurement Processes for the Provision of Delmarva Power’s Standard Offer Service Final Report and Recommendations” (“Final Report”) on April 29, 2016. Staff held a workshop on July 28, 2016 to discuss the Final Report with stakeholders, with a subsequent comment period.

In developing its recommendations LEI developed a set of evaluation criteria (after seeking input from different parties) which included:

- Lowering the costs of supply for Delmarva’s RSCI customers
- Efficiency and consistency with competitive markets or the likelihood of procurement results to be comparable to those in competitive wholesale markets for the same product being purchased;
- Consistency with Delaware policies, which emphasize reliability of supply and stable prices at the lowest possible cost;
- Balancing benefits and costs to ensure the least cost to consumers with a transparent procurement process, a competitive process minimizes risks.
- Ease of implementation to evaluate the levels of regulatory requirements or administrative burden(s) and costs for the SOS provider.

Four different procurement strategies were identified which are consistent with statute and could be implemented either individually or in combination:

- Direct procurement from the PJM spot markets
- Long-term contracts
- Own generation (build/buy)
- Procurement of FRS contracts from wholesale suppliers (Status Quo)

The pros and cons of each procurement method were discussed in LEI’s Final Report. Purchases from the spot market reflect the underlying costs of electricity but have large variability in year-over-year supply costs. Long-term contracts offer price stability through fixed supply costs but can deviate in either direction from actual wholesale market prices. FRS supply contracts are priced according to wholesale market expectations and laddering can smooth annual price fluctuations or supply variability. The SOS provider can also own generation resources; these costs may deviate from wholesale market prices and come with additional costs for operations, maintenance, and complying with PJM’s rules.

LEI assessed the following quantitative and qualitative factors for each individual procurement strategy:

- Supply cost

¹⁵ Request for Proposals for Professional Services, Contract Number STA15129PSCDPLSOSR.

- Supply cost variability¹⁶
- Administrative cost
- Other considerations such as ease of implementation, consistency with Delaware policies and goals, consistency with wholesale markets, and regulatory/legal considerations.

Five scenarios were used to analyze the RSCI SOS procurement methods; they included historical prices and hypothetical historical prices (2007-2015 delivery periods) and forward-looking analysis for the period 2016-2025. The forward-looking analysis included:

- Base case weather-normalized outlook for energy and capacity
- Low price weather-normalized outlook for energy and capacity
- Price shock – hypothetical scenario over the 2016-2025 period featuring sharply increasing, then declining, electricity prices which would be projected to the wholesale supplier
- High migration – hypothetical scenario featuring a high RSCI SOS customer’s migration rate of 40% over two years, leading to lower than forecast in the 2014 IRP. This would correspond to approximately 53% of RSCI load in Delmarva’s service territory being served through SOS.

To determine variability, LEI first modeled the historical period from 2007-2015. Historical year over year costs have been higher than those projected for the period 2016-2027. Evaluation of historical costs include all changes in the markets (wholesale and fuel) as well as actual weather conditions; future projections are not able to foresee all such impacts, resulting in a lower variability for the forward-looking analysis. In contrast with fixed price FRS contracts, procuring SOS supply via spot market purchases results in lower overall prices but significantly higher variability. If the SOS provider purchased directly from the spot markets, they would bear all risks associated with such variability, and could not pass such risk to the wholesale electricity suppliers who provide the FRS contracts.¹⁷ LEI calculated the historical (2007-2015) year-over-year variability of purchasing directly from the spot market as \$24.4/MWh, compared to the historical (2007-2015) 3 year FRS contract year-over-year variability of \$5.1/MWh.

Concerning their review of changing procurement parameters of the FRS contracts, LEI did not find that changing contract parameters such as length, block size, procurement period, or auction mechanism would significantly impact SOS supply costs. Notably, the analysis did find that the risk premium of approximately \$10/MWh¹⁸ that is embedded in the bid price would decrease with contract length.

LEI also analyzed long-term contract procurement. Long-term contracts allow the SOS provider to secure a fixed amount of energy and capacity at a given price therefore ensuring greater price stability for supply. This procurement method would emphasize price stability, but can result

¹⁶ See Final Report, Appendix B 8.4.2.

¹⁷ Due to the SOS supplier’s obligation to serve and right to recover costs associated with SOS, Delaware ratepayers shoulder any risk borne by the SOS supplier.

¹⁸ *Supra* n.16, at 8.2.3. Assumes fees of the third party providing the reverse auction platform, and paid for by the winning bidder(s) are embedded in the \$10/MWh risk premium.

in deviations in either direction from prevailing wholesale market prices. Such deviation could result in two separate impacts depending on the direction of the deviation. If the long-term contracts resulted in prices significantly below the prevailing wholesale price, such contracts could harm the competitive retail electricity market in Delaware by providing a low SOS price with which competitive suppliers could not compete. Also increasing market prices could cause rate shock for customers when the contracts expire. In contrast, if these contracts resulted in higher-than-prevailing prices, significant amounts of load could migrate from the SOS product to retail electricity suppliers, potentially stranding these contracts. The risks due to load migration would be borne by the SOS provider and could require below-market sales of contracts for energy and capacity.

The option of having the SOS provider build or purchase its own generation assets was not recommended. Due to the small size of RSCI SOS load as well as the market risks inherent in ownership of generation, the SOS provider would not benefit from the economies of scale afforded to owners of larger generation portfolios. In this scenario, the SOS provider would bear similar risk of load migration which could result in stranded costs and the resulting higher prices for SOS ratepayers.

Ultimately, LEI recommended a portfolio that consists of approximately 30% in two-year FRS contracts; 40-45% in ten-year long-term laddered fixed quantity contracts procured every five years, and 25-30% spot market purchases. The long-term contracts contemplated by LEI would act as a hedge and would not follow variations in load but rather cover base load.¹⁹ Shorter-term contracts, both FRS and spot market, would be load following. The combination of FRS contracts and spot market purchases according to LEI will ensure that the price for the majority of supply follows the trends in wholesale market conditions. Supply provided through long-term contracts and FRS contracts creates price stability in the portfolio. The contemplated long-term contracts would procure approximately 40% of the megawatts of peak load (capacity) and 40% of the energy requirement, with half of the 40% requirement procured in the form of ten-year contracts every five years. LEI's portfolio procurement method would result in moderately higher variability of supply costs by an average of approximately \$2/MWh/yr when compared to the status quo FRS procurement as well as an increase in the administrative requirements for the SOS provider. LEI estimated the approximate price of these administrative services (including accounting and settlement), which would be accomplished by either Delmarva or a third party working on its behalf, are in the range of \$1-2/MWh.²⁰

Based on LEI's modeling given current market knowledge, this portfolio is projected to be approximately 8% less expensive than the forecasted costs of the status quo FRS procurement option. The tradeoff is an increase in the variability of supply costs resulting from the portfolio approach by an average of approximately \$2/MWh/yr over FRS contract procurement. The

¹⁹ "Base load" refers to some amount of electricity demand that is always required, regardless of time of day or year.

²⁰ *Supra* n. 16, at n. 27. "LEI has worked with clients seeking scheduling services, where the combination of the flat fee and "per MWh" fee for such services resulted in approximate costs in the range of \$1/MWh to \$2/MWh."

resulting reduction in average supply costs would be greater than the average increase in variability of supply costs. LEI asserts retail electric suppliers could benefit from such a portfolio approach with increased variability since SOS rates would more closely follow wholesale market prices.²¹

LEI stated that additional discussion, modeling, and testing may be necessary to refine the optimal risk-adjusted portfolio such that it would provide the lowest overall supply costs with an acceptable level of variability and price risk.

Overview of Comments on LEI's Final Report

Delaware Division of the Public Advocate ("DPA") Comments

The DPA found LEI's Final Report useful in evaluating alternative approaches that the Commission might adopt and agrees with some of the conclusions and recommendations.

The DPA states that "the optimal residential SOS portfolio should reflect a balancing of several important objectives." "These objectives can reasonably include: (1) obtaining a low price; (2) ensuring price stability; and (3) maintaining consistency with market prices to help foster retail competition."²² The DPA's greatest concern is obtaining the lowest possible price for residential SOS customers while maintaining reasonably stable prices. The DPA does not believe that the goal of developing a competitive retail electricity market should be met at the expense of obtaining low and stable power supply prices.

The DPA pointed out that there are "certain inherent limitations in the kind of analysis and modeling that LEI conducted that need to be recognized in the interpretation of LEI's results and the implications of LEI's recommendations". Changes to inputs²³ and a longer time horizon negatively affect the degree of uncertainty. Risk premiums in LEI's Final Report are considered static regardless of the product portfolio and contract length. The DPA stated in the July 2016 workshop that changing elements of the portfolio changes the risk profile associated with the FRS products. Potential increases in load uncertainty will lead to volatility and may result in higher prices for the FRS. The DPA also had concerns about the method used in the Final Report to measure variability. The measurement of variability used was the change of the year-over-year delta, , e.g. if the supply cost increases \$10/MWh/yr there would be zero variability as measured in the Final Report.

The DPA thought that the market for fixed-price contracts of duration of 10 years particularly for capacity may be extremely limited. Because of limited liquidity it may be difficult to

²¹ *Id.* at 10, ¶3.

²² Comments of the Delaware Division of the Public Advocate on the Report of London Economics International, Inc. Regarding the Composition of the Power Supply Portfolio for Delmarva Power & Light Company's Standard Offer Service at 3.

²³ *Id.* at 5. Input assumptions either explicit or implicit are: fuel prices, power plant construction costs, transmission infrastructure, load growth, load shape and environmental policies.

determine whether a price for such a contract is reasonable or competitive. Assuming fixed-price, ten-year contracts for capacity were available; such a contract could include significant risk premiums for which ratepayers would be responsible. Furthermore, to the extent that including long-term contracts in the SOS power supply portfolio proves to adversely affect SOS customers, those adverse effects may be long-lived due to the fact that the contracts are for ten years and their adverse impacts therefore not quickly ameliorated. The DPA also asserts that the existence of long-term contracts in a portfolio also has the potential to increase the risk premium for the FRS contracts in that portfolio. In that instance, FRS contracts would be required to serve a percentage of load, potentially leading to volatility of obligation as customers leave and return to the SOS service. This volatility and increase in load uncertainty could result in a higher risk premium for FRS contracts within a portfolio that also contains fixed-price long-term supply contracts.

The DPA believes the Commission should not pursue LEI's portfolio approach, but rather consider changing the duration of the FRS from three years to two years, or a blend of two-year and three-year FRS. They further recommend reducing the time between suppliers providing bids for the FRS and the acceptance of those bids. Currently, the time for approval of the bids is two days.²⁴ Additionally, the DPA recommends excluding a spot market component from the residential supply portfolio since inclusion would increase variability in the portfolio and may also entail added costs for Delmarva's administration of the SOS.

Delmarva Power & Light Company Comments

Delmarva asserts that the current three-year ladder FRS contracts for SOS insulate the customers from significant annual price swings. Prices have been relatively stable or declining since the start of the three-year ladder FRS contracts. Because of the terms and conditions of the contracts, Delmarva's ratepayers are not subject to price volatility from extreme weather conditions, such as the Polar Vortex in 2014. They claim the current SOS procurement process satisfies three key criteria: price stability, supply reliability, and lowest cost to ratepayers. Delmarva maintains that price and supply reliability cannot be forsaken to achieve the lowest cost. Or as they stated "the lowest cost must be for a reliable supply of stably priced electricity."²⁵

Delmarva notes that the purpose of SOS is to provide a stable, less risky, well priced supply alternative for those customers who, for whatever reason, do not choose a third party supplier. Delaware customers already receive the benefits of competition because SOS suppliers who currently provide contracts employ in-depth techniques for hedging future supply to provide the lowest price in pursuit of winning portions of SOS load obligations. These wholesale suppliers are experts in modeling and risk management and capitalize on economies of scale by spreading the costs over a large number of customers with loads much larger than Delmarva Delaware. The vast majority of the winning SOS suppliers own significant generation resources. The FRS construct

²⁴ Delmarva's Request for Proposals for Full Requirements Wholesale Electric Power Supply in Delaware allows two days for the Delaware PSC to approve bids; Delaware PSC precedent has been approval one day after transactions are executed.

²⁵ Written Comments of Delmarva Power & Light Company In Response to the April 29, 2016 "Final Report and Recommendations" of London Economics International, dated 8/31/2016 at 5.

insulates customers from numerous supply risks, including load, weather, market volatility, and price.

For long-term fixed quantity contracts (capacity and energy) Delmarva notes the volumetric risk with its potential for significant losses is borne by SOS customers through the impact on SOS rates. Currently, FRS contracts are load following which means the SOS suppliers are required to match the full real time customer load requirements at the fixed contracted price, resulting in no excess, shortage, or stranded costs. Ten year contracts carry price uncertainty because long-term power forward curves are difficult to assess for periods longer than three years and therefore carry significant risk premiums. Significant risk is associated with long-term market pricing for commodities as Delmarva demonstrated by their three current wind contracts for energy and Renewable Energy Credits. Contracts that are priced under market when they expire can cause price shock for customers when replaced by contracts at higher market prices. Long-term contracts considered by LEI did not include imputed debt. Rating agencies recognize such contracts as debt on a utility's balance sheet. The effect of that imputed debt is that equivalent equity must be raised by the utility to offset the imputed debt

In the July 2016 workshop, Delmarva indicated that the administrative costs to manage a portfolio would be more expensive than the \$2/MWh/yr that LEI used in their analysis.²⁶ Delmarva stated that it does not have the resources and they would need to acquire specialized employees, capital, software, and technology.

Under LEI's portfolio approach, the two-year FRS contracts would only include 270MW of load which may be too small to attract bidders. Delmarva asserts SOS suppliers are more likely to use their resources to participate in more substantial procurements in other jurisdictions with significantly larger loads. This could result in less competition and higher market prices.

Delmarva cannot support LEI's recommended portfolio approach. In the above-mentioned workshop Delmarva stated changing the FRS contracts from three year to two year terms would decrease the risk premium. Maryland employs two year FRS contracts for procurement of their SOS load equivalent (although not in the same number of tranches as Delmarva Delaware) and Delmarva stated they have worked out fine.

Retail Energy Supply Association ("RESA") Comments

RESA has for years advocated that the current ladder three-year annual procurements utilized by Delmarva, where the contract prices that Delmarva pays for its SOS supply are averaged together and reduced to a retail rate that changes twice per year, is not a model for the development of a robust, sustainable competitive retail market. They note that three-year ladder contracts means that, at all times, there is a lag between the SOS rate and underlying wholesale market prices because the SOS rate includes electricity prices that are three years old. If there is a reasonable likelihood that sustained periods of time will arise in which a supplier cannot compete

²⁶ Transcript of Workshop for Dkt No. 14-0283, July 21, 2016 at 187: Mr. Giovannini stated that the administrative cost "is higher than \$2/MWh. It is more expensive....we would have to sit down and figure out what you factored in versus what I experienced. But it is definitely expensive."

for business in a particular market because wholesale prices are higher than the locked-in SOS rate – and Delmarva’s SOS is the largest competitor with the largest market share by far – then RESA claims the supplier will simply avoid that market or not offer specific products in that market that are based on price competition as opposed to other value-added options. The result is a market that is devoid of true competition.

RESA recommended that: (1) the SOS procurement structure for residential and small commercial customers be modified to transition from the current three-year supply contracts to one-year contracts; and (2) the SOS procurement structure for all other non-residential customers²⁷, with the exception of GS-T customers, be modified to transition from the current one-year supply contracts to three-month supply contracts. RESA’s procurement proposal will also prevent above-market SOS rates for extended periods of time. Customers can then compare these value-added products and services with those offered by other electric suppliers, as well as SOS, and choose the combination that best meets their needs. First, RESA claims the current model impedes the growth of retail competition because the longer-term three-year contracts can become out-of-market quickly and result in intermittent, “boom/bust” scenarios as opposed to continuous and sustainable competition. Rather, to realize a robust, sustainable competitive market, retail suppliers need to be able to compete at all times and, by doing so, can offer products and services that go beyond price comparisons and involve a wealth of other products and services, including renewable energy, bundled products, affinity relationships, products dependent on smart meter data, and so forth.

According to RESA, the Final Report fails to mention that, generally, retail suppliers have shown they are not inclined to participate in jurisdictions that utilize longer-term contracts and, therefore, regardless of where wholesale prices are, customers concerned solely about price have few if any options from which to choose. The three-year procurement contracts in New Jersey and the District of Columbia are very similar to those in Delaware, and are a significant reason for the lack of shopping in those jurisdictions. RESA claims this will be a problem for customers when SOS rates are high compared to the market price and those same customers have few or no competitive options to lower their electricity costs or to experience other benefits from the competitive marketplace. The longer the lag between energy procurement and delivery, the more likely the SOS rate will diverge from current market prices at the time of delivery. RESA encourages the Commission to transition to a market reflective procurement structure to promote competition. RESA stated that they “believe[s] that SOS can and should be fulfilled by a competitive retail supplier or suppliers rather than Delmarva.”²⁸ RESA understands that while some legislative changes may be needed in order for that transition to occur, “RESA recommends that the Commission consider the transition to competitive supplier-provided default service in this proceeding.”²⁹ They assert having Delmarva as the provider of SOS creates “structural barriers that hinder competitive market development, to varying degrees based on customer class, ultimately preventing customers from achieving the benefits of a fully workable and competitive market.

²⁷ This docket focused only on Residential and Small Commercial-Industrial customers.

²⁸ Comments of Retail Energy Supply Association Docket No. 14-0283, 8/31/2016 at n. 17.

²⁹ *Id.*

RESA's recommendation is for the Commission to consider annual SOS supply contracts with the ultimate goal of quarterly supply contracts.

Exelon Generating Company, LLC's Comments

Exelon Generating Company, LLC. ("ExGen") states that FRS suppliers are responsible for serving the load every hour regardless of volume change or the reason for the change³⁰. They further note that LEI's proposed portfolio approach with long and short-term contracts and spot market purchases deprives consumers of the expertise wholesale FRS suppliers provide in terms of better hedging resulting in lower energy prices. ExGen states that "wholesale suppliers rather than independent consultants or utilities themselves – provide the most cost-effective method of SOS supply management for utility load. Wholesale suppliers are the experts in the area of risk management, and have greater resources, expertise and ability to appropriately manage risks and supply at least possible cost."³¹ They claim savings achieved as a result of their sophisticated risk management skills are passed on to ratepayers in the form of more competitive bids for SOS supply.

ExGen examined the risk of long-term contracts which can be either higher or lower than the current default service rate over the long-term and thought they pose a risk of stranded costs to the utility when competitive suppliers are able to offer less expensive products and assume the risk when load migrates from the utility. With long-term contracts the utility could face the obligation for contract payment for load that no longer exists. They believe that there could be a lack of market liquidity for 10-year energy block products and this could result in uncompetitive rates for which there is no benchmark against which to assess competitiveness of such bids.

ExGen suggested that the Commission consider the terms of the FRS contracts and frequency of procurements but not abandon the current approach for LEI's recommended portfolio approach which could result in more price volatility or prices that diverge greatly from the competitive wholesale market.

Staff Review

In Chapter 10 of Title 26 of the Delaware Code, the General Assembly declared that electric distribution companies have an obligation to serve their customers by providing SOS which is safe, adequate, efficient, and reliable.³² The General Assembly also emphasized in several sections of the statute that procuring electricity at the lowest cost to customers and price stability are paramount considerations. As such, it mandated "at least 30 percent of the resource mix of DP&L shall be purchases made through the regional wholesale market via bid procurement or auction process held by DP&L. Such process shall be overseen by the Commission subject to the procurement process approved in PSC Docket No. 04-391 as may be modified by future Commission action."³³ DP&L is also required to conduct integrated resource planning ("IRP") to "systematically evaluate

³⁰ I.e. weather or migration to other suppliers.

³¹ Comments of Exelon Generation Company, LLC on the London Economic International LLC's Final Report at 2, 3.

³² 26 Del. C. § 1010 (a).

³³ 26 Del. C. § 1007 (c)(1)a.

all available supply options during a 10 year planning period in order to acquire sufficient, efficient and reliable resources over time to meet its customer's needs at a minimal cost."³⁴

The portfolio approach that LEI recommended for securing Delmarva's SOS discussed above consisted of approximately 42% long-term (10 year) supply contracts, 28% spot market purchases, and 30% FRS two year ladder contracts. LEI stated that a portfolio approach may require additional modeling and testing to refine the optimal portfolio to provide a "lower expected average supply costs with an acceptable level of variability and price risk."³⁵ Furthermore, with time, it might be reasonable to readjust the ratios of each procurement method within the portfolio so as to maintain an optimal balance of risk and cost of supply."³⁶ LEI's recommendation was based on simulation modeling and market conditions as known at that time. Their recommended portfolio is expected to result in a reduction of 8% or \$7/MWh as compared to the current three year FRS contracts. The tradeoff is "a moderately higher variability of supply costs relative to FRS procurement, as well as increase administrative requirements for the SOS provider."³⁷

Staff was persuaded by comments from stakeholders on several issues concerning the proposed portfolio approach. Staff agrees with commenters that risk management capabilities would have to be attained by the SOS provider to successfully manage the proposed supply portfolio; ultimately the ratepayers would shoulder those costs and bear any associated risk. Comments from Delmarva and ExGen stated that wholesale suppliers (which could be marketers and/or generation owners) are much better equipped to optimize supply portfolios and to bear the resulting risk than the SOS provider. Wholesale suppliers, which bid on the FRS contracts, already have expert employees in place to manage risk on a daily basis with a larger and more diverse portfolio potentially including physical assets and financial instruments.

Several commenting parties questioned the risk of 10 year long-term contracts. One form of risk in long-term contracts of this length is the potential to lag behind market prices and provide SOS customers with lower supply costs than shorter term contracts. At the end of the long-term contract customers could be subject to greater volatility in rates as those long-term contracts are replaced by those at prevailing wholesale market prices, which could result in a phenomenon known as "rate shock". Conversely, risk also exists in declining price conditions, where longer term contracts provide SOS customers with higher supply costs than shorter term contracts. All parties including LEI agreed that the size of the long-term contracts would have to be carefully monitored since a portfolio including too small a percentage of long-term contracts may increase the exposure to the spot market and too large a percentage of such contracts may increase the risk of stranded cost if increased load migration happens. Several parties questioned the competitiveness of the 10 year contracts and whether the market for such products was liquid enough to produce competitive results. Delmarva stated that when they held generation (through their affiliate Conectiv) most contract lengths were three years and under. After hearing and reading the parties' comments,

³⁴ 26 Del. C. § 1007 (c)(1).

³⁵ *Supra* n. 16, at 74.

³⁶ *Supra* n. 16, at 10.

³⁷ *Supra* n. 16, at 74.

Staff had serious reservations concerning the availability and competitiveness of 10 year contracts and the potential risk associated with stranding of these contracts.

Another consideration in implementing LEI's proposed portfolio approach is the administrative costs for the SOS provider³⁸. For FRS procurement and contracts, administrative costs are relatively limited³⁹ since Delmarva uses a web-based auction platform those fees are embedded in the supplier's bids. With FRS many administrative costs for managing the portfolio are assumed by the wholesale supplier who acts as the load serving entity ("LSE"). Delmarva maintained that a managed portfolio would increase the administrative costs for the SOS provider. Based on LEI's experience they estimated ongoing administrative costs at \$1-2/MWh. Delmarva stated they believed their administrative costs on an ongoing basis for portfolio management would be more expensive than LEI's projection. Also, Delmarva noted that necessary start-up costs would also have to be factored in, further inflating the estimated administrative costs.

The DPA and Delmarva were favorable to decreasing the FRS contract length from three years to two years. In their comments ExGen suggested that the Commission consider the terms of the fixed price FRS contracts and frequency of procurements but not abandon the current approach for a portfolio approach which could result in more price volatility or prices that diverge greatly from the competitive market. RESA's recommendation that would not require legislative change is for the Commission to consider annual SOS supply contracts with the ultimate goal of quarterly supply contracts.

LEI modeled various FRS contract lengths. For three year contracts the historical (2007-2015) actual average price was \$92.8/MWh⁴⁰ with a variability of \$5.1/MWh/yr; the historical hypothetical two year FRS contracts had an average price of \$91.3/MWh and a variability of \$6.3/MWh/yr; and the historical hypothetical one year FRS contract had an average price of \$89.9/MWh and a variability of \$8.4/MWh/yr. Using two year contracts instead of three year contracts would have resulted in a decrease of costs of \$1.5/MWh for each \$1.0/MWh/yr increase in variability⁴¹. For the historical period going from a three year contract to a two year contract was more beneficial than going from a three or two to a one year contract⁴². This is due in part to the fundamental changes in market drivers observed in the past 10 years⁴³. The historical variability is

³⁸ PSC Order No. 6746 (October 11, 2005) ¶23: "The reasonable allowance for retail margin ("RARM") mandated by the Act is comprised of several elements: (1) incremental expenses incurred (a) to provide fixed price SOS and HPS; (b) to administer the VRM applicable with respect to fixed price SOS customer load; and (c) carrying costs on Cash Working Capital for fixed price SOS and HPS; (2) \$2.75 million per 12-month period, which for the Year 1 and Year 2 rates, is deemed to include any carrying costs on incremental capitalized costs associated with providing fixed price SOS and the VRM, ...; and (3) for GS-T customers and those in the GS-P class that have elected HPS, the allocable share of the above categories plus an amortized amount, including carrying costs on the unamortized balance of the capitalized billing system software costs and interface costs needed to bill and track HPS costs and expenses."

³⁹ See Delmarva's Application, Docket No. 17-0164 p. 63, Estimated Annual Ongoing [Administrative] Costs are \$0.000224/kwh which equates to \$0.224/MWh.

⁴⁰ *Supra* n. 16, at 32, Figure 10.

⁴¹ *Id.* at 54, ¶2.

⁴² *Id.* at 54, ¶2.

⁴³ *Id.* at 28.

relatively high compared to the projected future period since forward outlooks do not foresee all impacts. Due to the laddering in the status-quo three year contract procurement paradigm, the decline in supply costs has lagged behind the decline in the wholesale market prices. Shorter term contracts would better align supply costs with prevailing market prices.

The forward projections for the Base Case and Low Price scenarios result in relatively small differences in cost and variability between FRS contracts for one, two and three years. In the Price Shock scenario, since it is assumed that suppliers do not anticipate market changes, supply costs for shorter period FRS contracts exhibit a lower average cost but higher variability. It is easily understood that in rising price conditions longer term contracts will lag behind market prices and provide lower average supply costs than shorter term contracts. Conversely, in a declining price market, longer term contracts will provide customers with higher supply costs than shorter term contracts.

Delaware's SOS load is smaller than neighboring states but has typically attracted a sufficient number of participants to ensure competitive results. Each year's current RSCI tranches for three year contracts totals approximately 256 MW of Peak Load Contribution ("PLC"). The load is auctioned off in blocks of approximately 50 MW which is similar to offerings from other states.

The auctions are timed so that they are close to the start of the delivery periods so as to reduce the risk to suppliers which exists between the time the offer is submitted to the start of the delivery year. Typically, the auctions are held at the end of November and the beginning of February. This timing allows the insertion of a third tranche if necessary and also allows the winning supplier to nominate their Auction Revenue Rights ("ARR") to which they are entitled to as LSEs. ARRs are allocated in March for the next planning period which starts June 1.

As one of the criteria used to evaluate SOS procurement approaches, LEI looked at efficiency and consistency with competitive markets or the likelihood of procurement results being comparable to those in competitive wholesale markets for the same product being purchased. This criterion also addresses concerns of participants in competitive retail markets. LEI considered such effects in their analysis. Two-year FRS contracts as opposed to three year contracts would very marginally increase variability but trend more closely to wholesale market prices as well as increase the load auctioned off each year. Migration to Third Party Suppliers from SOS would reduce the SOS load. The State of Delaware exclusively contracted with Direct Energy for two year fixed retail contracts which could cause SOS customers to migrate potentially resulting in a PLC reduction. For the 2017 delivery year the PLC for the RSCI customer class has decreased from 261.5 MW (2016 delivery year) to 249 MW. Two-year FRS contracts would increase the amount of load auctioned each year from approximately 249 MW to approximately 373 MW assuming no further reduction in PLC. If the PLC continues to decline the option of procuring two-year contracts would help entice sufficient participation from potential suppliers given the administrative requirements for qualifying in the auction. Retaining the two tranche process, with one tranche in November and one tranche in January, allows some mitigation of market conditions.

Staff Recommendation

Staff recommends that the Commission approve a transition from three year ladder fixed price FRS contracts to two year ladder fixed price FRS contracts for Delmarva's procurement of SOS supply. This alternative has been recommended and, in Staff's view aptly supported, by Delmarva and the DPA. ExGen suggested that the Commission consider the terms of the fixed price FRS contracts and not abandon the current approach which two year FRS contracts would do. Two year FRS would more closely follow the wholesale market conditions which RESA also encourages to promote competition. In a declining price market SOS customers would see prices decline at a more rapid rate. This docket had participation from various groups in the public workshops and as cited above several entities submitted written comments on the final report.

Staff recommends that each delivery year be comprised of 2 tranches with the same time frames as currently used. The tranches for each delivery year would request supply for 50% of the load and would be ladder to replace expiring existing two-year FRS contracts. A transition period starting with the first tranche for the 2018 delivery year needs to occur to move from the three year to the two year FRS contracts.